THE ALDRICH BANKING PLAN

BY CHARLES A. CONANT

THE plan which had been submitted by Senator Aldrich to the National Monetary Commission in regard to a central Reserve Association for the purpose of co-ordinating the banking system of the country, gives a definiteness to the discussion of banking reform which it has heretofore lacked. Since the panic of 1907, the advocates of changes in the banking system have each argued in favor of his particular view of what such changes should be; while the defenders of the existing system of isolated local banks have set up a figure of straw, rigged out with all the discarded rags of the banking blunders of eighty years ago, labelled the manikin "central bank" and proceeded to demolish it,—not alone as an enemy of the finances, but of the political liberties of the country. The advantage of a definite project, like that of Senator Aldrich, is that it permits each item to be taken up and its merits threshed out more definitely than when each side has had the advantage of setting up its own ikon or bad spirit, and burning incense or pouring out anathema before them accordingly.

It is indicative of the tact and skill with which Senator Aldrich has dealt with the matter that the new project, while it is not flawless, already has the endorsement of many close students of the subject and embodies details which they recognize as their own. The fact that it has been so favorably received indicates the progress which has been made in financial thinking within the last few years. The experts in monetary matters who were derided fifteen years or so ago as cranks or extremists have seen public opinion follow them from one mile-stone to another on the road to sound finance. Time was when advocacy of the single gold standard was denounced, even by men of moderate views, as radical and impracticable. The gold standard became law in 1900. Then came the battle for basing currency upon

the movement of the commercial affairs of the country instead of upon United States bonds. Again the advocates of the reform were denounced as wishing to issue currency without security, but again they won their battle when issues upon commercial paper were recognized by the Aldrich-Vreeland law of 1908. That United States bonds were not the proper basis for currency was long pooh-poohed by the politicians, who insisted that this country had "the best money in the world"; but the present progressive Secretary of the Treasury has finally recommended that bonds be issued which shall no longer be available for circulation, and a bill to this effect has been enacted by Congress.

From the experience of the panic of 1907 stood out, even more forcibly than before, three cardinal defects in the existing American banking system—the lack of power to issue currency to meet legitimate needs; the scattering of reserve money among twenty thousand competing banks, instead of its concentration at central points where it could be used effectively; and the lack of co-ordination and leadership in meeting monetary disturbances.

The lack of power to issue notes was met after a fashion by the Aldrich-Vreeland act; but that this was only a makeshift was admitted by the very terms of the act, whose provisions expire on June 30th, 1914, and which provided for the appointment of the National Monetary Commission "to inquire into and report to Congress at the earliest date practicable what changes are necessary or desirable in the monetary system of the United States or in the laws relating to banking and currency."

It is to comply with this mandate that the Aldrich plan has been prepared and laid before the Monetary Commission. It seeks to meet the need for a more flexible currency by transferring to a central institution, to be known as the Reserve Association of America, the note-issuing functions of the existing seven thousand national banks and the general regulation of the money-market. The present circulation of the national banks based upon bonds is about $690,000,000. This is to remain the limit of the "authorized circulation," so to speak, even after the bonds are gradually gotten rid of. Above this fixed limit Senator Aldrich proposes to superimpose additional note issues to the amount of $100,000,000 under a tax at the rate of three per cent. per annum; $100,000,000 at four per cent.; $100,000,000 at five

per cent.; and any additional amount found necessary if a tax is paid at the rate of six per cent.

Such provisions mean, in effect, that there can be no currency famine and no panic about getting currency so long as anybody has good assets to exchange for currency. If the demand for currency becomes acute, the Reserve Association will meet it by availing itself of the issues subject to tax. Before it is required to pay a tax as high as six per cent., it will be able to issue $300,000,000 in notes beyond the usual limit. This system of taxing excess issues follows the system of the Imperial Bank of Germany and the Austro-Hungarian Bank. At those institutions excess issues are taxed uniformly at the rate of five per cent. The plan of Senator Aldrich has the advantage in respect to flexibility that $200,000,000 in new notes can be issued at rates of taxation not higher than four per cent. The imposition of a tax does not conform to scientific monetary principles, but will probably do little harm if the limit of untaxed circulation is raised from time to time to meet the increase in permanent currency needs.

The other two important defects in the existing system which have been referred to,—the scattering of reserves and the lack of leadership in emergencies,—are met by other provisions of the Aldrich plan.

The Reserve Association will be custodian of the ultimate reserve of gold. If the current redemption of the greenbacks and the gold certificates, as well as of bank-notes, is transferred to the association, it will possess ultimately more than a thousand millions of dollars in gold, which will be the largest concentrated stock in the world. This will afford at once an assurance of adequate reserves against issues of notes at home and of coin and bullion to meet demands for export.

Under a system which permits the central banking mechanism to meet emergencies by rediscounting for other banks and issuing its notes to cover such rediscounts, the movement of reserve money will be the opposite of what it was in 1907 under the American system of isolated banks, each required by law to maintain certain specified reserves. If deposits by local banks with the central institution could be counted as a part of their reserves, such deposits would tend to increase, instead of to decrease, in periods of pressure. The banks which felt that their reserve resources were

inadequate would obtain rediscounts from the central institution, and the amount of such rediscounts would be carried in the first instance to their credit in their deposit account. If they anticipated heavy demands upon them, they would still further endeavor to increase their deposit account at the central institution by paying in the proceeds of their collections in order to give strength to their reserve balance.* They would thus be in a position, when deposits were withdrawn or other demands were made upon them, to draw checks on their account upon the central institution, which would be in most cases the safest and most acceptable form of payment.

The essential function of the central bank will be, therefore, with one hand to deliver its own notes without stint for legitimate internal uses and with the other to dip into its gold resources to meet all demands for the export of the yellow metal. But it will not, like the Treasury of the United States during the depression of 1893-96, be a helpless looker-on as its gold is drained away by the presentation of checks and notes for redemption. It will have in its hands the weapon which has been found almost universally effective at European central banks during the past fifty years—the control of the rate of discount. If gold is flowing out more freely than the governor of the central bank considers prudent, he will recommend to the governing board that the discount rate be advanced, to the end that there shall not be a profit in withdrawing capital from America and lending it elsewhere, and that there shall be a profit in retaining in New York foreign funds which might otherwise be exported.

It is this power of the officers of the central bank to take prompt and resolute action to influence the market through the rate of discount which is the key to the whole structure of a central banking mechanism. It is through this power that the governor of the central bank assumes leadership in the money-market and is recognized by other bankers as entitled to such leadership. It is his function to look ahead, to study conditions in foreign markets, to watch the ebb and flow of capital and credit between New York and the interior, and when he believes that a gold export movement is threat-

* This has been the actual experience of the Bank of England, since confidence has been established that the Bank would not be fettered in meeting requirements. *Vide* the author's "History of Modern Banks of Issue," Fourth Edition, p. 131.

ened beyond the legitimate requirements of commerce, to resolutely advance the rate of discount and to ask the support of the other banks in so doing.

There are many ways of influencing the market and securing the co-operation, cordial or reluctant, of other banks, which there is not space to discuss in this article. The essential point is, however, that the governor of the central bank not only has the power to meet a crisis when it arises, but the duty is imposed upon him of seeing that it does not arise. Under the present banking system, no such power is lodged with any individual, any public official or any banking board. It is only when the crisis becomes so acute that hesitations and jealousies are stilled under the imperative motive of self-preservation that other bankers acquiesce in the appearance of a strong figure on the quarter-deck of the storm-tossed craft of American banking and consent to his seizing the helm and enforcing discipline at the pistol's point.

So much for the functions which a central banking mechanism is designed to fulfil and which it has successfully fulfilled in the most advanced European countries during the past fifty years. The question which is more immediately practical, however, to the business man is whether such a system will afford benefits visible and tangible to the business of the country.

Will the Aldrich plan, if enacted into law, enable the business man to borrow more readily on good security?

Will it enable him to count with assurance on a rate of interest reasonably uniform?

Will it protect him against the sudden tightening of the strings of bank credit when he needs it most, subjecting him to the inconveniences and worries of panic conditions?

Will it enable him to buy his raw material, convert it into finished goods and lay those goods down in foreign markets on terms which are as favorable in respect to credit as those obtained by his foreign competitors?

Let us consider briefly the answers to these questions.

1. Borrowing on favorable terms to carry on commercial operations is promoted in many ways by a central banking mechanism. Such a mechanism, if it brings the scattered parts of the banking and credit system into closer co-ordination, facilitates the movement of capital from localities where there is an excess to those where there is a deficiency

in relation to the demand. It often happens in an interior community that local enterprises do not absorb all the banking resources of the community. In such cases the surplus, even under the present system, usually goes to New York. There, under the present system, it is loaned to a large extent on call for the purposes of stock-exchange speculation. In the mean time, there may be other communities where manufacturing or commercial exchanges are going on in such volume and with such rapidity that local banking resources are inadequate. For such communities, aid comes from outside by the selling of the commercial paper of local establishments and by obtaining rediscounts.

While a good deal of commercial paper is already being floated throughout the country in a somewhat unregulated and haphazard manner, direct rediscounting is comparatively rare. It is one of the merits of the central banking system that it affords an almost inexhaustible reservoir of credit, from which aid can be obtained, either directly or indirectly, by any sound business enterprise. While a central bank in the United States would discount only for the banks of the larger cities, the latter would in their turn be able to rediscount for institutions smaller and more remote. Thus an unhampered inflow of credit to a central reservoir and an equally unhampered outflow to all parts of the country would create a movement similar to that of the ocean in filling up to a uniform level and with a minimum of friction every nook and cranny where the supply was needed. Credit would be at the command of the sound and solvent manufacturer or merchant within limits fixed only by the relation of his need to the total supply of credit in the country.

2. From what has gone before, it is obvious that greater freedom in the flow of capital and credit would result in a nearer approach to uniformity in the charges for credit. It cannot be prudently predicted, of course, that in a new country, still absorbing enormous amounts of capital and still entering upon enterprises involving financial risks, rates of discount would fall so low or would remain so nearly uniform as at the Bank of France, with the great resources which, under the central banking system, it has been able to place at the command of French commerce. It is instructive, however, to glance at the discount history of the French Bank in recent years, as an illustration of the ideal towards

which central banking aims. At the Bank of France the rate fixed on May 19th, 1892,—two and one-half per cent. for commercial discounts,—remained unchanged for nearly three years, when it was reduced on March 14th, 1895, to two per cent. The rate rose during the South-African war as high as four and one-half per cent. for brief intervals, but on May 25th, 1900, was fixed at three per cent., and remained unchanged for nearly seven years until the shadow of the approaching panic of 1907 led in that year to some gradual advances. The maximum discount rate reached, however, on November 7th, 1907, while currency suspension and panic had paralyzed the markets of America, was four per cent.

These facts are cited, not to convey the impression that a central banking mechanism in America would at once reduce rates of interest on commercial loans to so low a level as in France, but to indicate the greater tendency towards uniformity in rates which can be counted upon when the scarcity of credit in a given locality can be redressed by the surplus in other localities, and equal distribution of credit can be promoted through a central reservoir, acting as a distributing centre for the existing 20,000 isolated banking units.

3. From the two considerations already set forth,—the ability of the central banking mechanism to promote the equal distribution of credit and its ability to maintain comparative uniformity of discount rates,—follows almost inevitably the third advantage of the system,—that it will safeguard the prudent man of business against panic. This is far from meaning that a central banking mechanism is a substitute for good business judgment on the part of individual manufacturers and merchants or that it will save them harmless from errors of over-production or ill-adjustment of costs to market value. It is not in the power of a central banking mechanism or any other device to put an end absolutely to periods of business expansion and contraction and to reduce to a dead level the flow of commercial production and distribution.

Panic, however, it is in the power of the central banking mechanism both to prevent and to cure. It prevents panic by taking note of the first danger-signals and applying the safeguards of an increased discount rate and intervention in the exchange-market to prevent the loss of gold. It meets serious conditions, if the`` arise, through its practically un-

limited resources for extending credit to those needing it temporarily by means of rediscount and the issue of notes. To put the matter in elementary form, without pausing here to set forth all its limitations,—the man who holds sound commercial paper and needs currency can obtain the currency by getting the paper discounted at his bank, and the latter can get it rediscounted at the central bank and obtain in exchange currency in the form of the notes of the bank.

Theoretically, the bank may issue notes to supply the need for currency up to the amount of the good commercial paper offered it for discount. Necessarily, it will keep a certain proportion of gold behind the notes, but with the command which it has over foreign exchange and its responsibility as the central reservoir of credit and gold in the country it can borrow gold freely abroad,—as the Bank of England has repeatedly done of the Bank of France,—and may thus support domestic credit, with no restrictions except those imposed by the character of the paper offered for discount and the prospect of the ultimate soundness of the economic system of the country.

4. If, from what has gone before, it is plain that the central banking mechanism will mean for business men a wider command of credit, a nearer approach to uniformity in charges for credit and the prevention of those paralyzing panics which bring business to a standstill, then it follows that in competition in foreign markets American manufacturers and merchants will be relieved from many of the impediments which they suffer under the existing banking system. If they enjoy more economical methods of production, more efficient machinery, lower freight rates and a better organized system of distribution, these advantages will no longer be neutralized by the defects of a system which imposes high and arbitrary charges for credit and sometimes absolutely refuses it.

One of the cardinal merits of a system of co-ordinated banking, with a central banking mechanism at the centre, will be the substitution of commercial banking for stock-exchange banking. In every European country changes in the rate of discount are determined primarily by the demand for commercial credit. In the New York market, on the contrary, it is the demand for money for speculation which fixes the rate to borrowers. It is the rate for call loans

which is quoted as the governing factor in the price of money and which determines in a large measure whether commercial credit be granted freely or whether it be refused.

This vicious system will be eliminated by such a central banking mechanism as Senator Aldrich has proposed,—partly by the exclusion of stock-exchange loans from the business of the Reserve Association, partly by giving greater negotiability to commercial paper. In the definition of the functions of the Reserve Association, as laid out by Senator Aldrich, there is no place for loans on stocks and bonds nor for investment by the association in such securities except those of the United States, the States of the Union and foreign governments. Thus, the central institution is taken out of the field of loans for the benefit of Wall Street and its great powers are consecrated to the service of the men who produce and distribute the wealth of the country.

The existing system of commercial loans in the United States is partly to blame for the fact that the rate for call money in Wall Street, rather than the rate for commercial discounts, is considered the index of the rate for short-term credit. Under the American system, the commercial loans and discounts are not readily convertible into cash,—at least not until maturity,—because they consist of single-name paper or credit granted upon bills receivable. A bank cannot readily rediscount such forms of obligation at another bank when it needs to reduce its loans and increase its cash. Under the European system, on the other hand, bills of exchange, drawn by a creditor upon his debtor, when accepted by the latter or by a bank representing him, bear such number and quality of indorsements that they are readily salable to another institution or to a private investor.

The policy of rediscount by the Reserve Association will have a tendency to encourage the use of acceptances in this country, which is one of the greatest merits of the plan of Senator Aldrich. When to this is added the further provision that the Reserve Association shall have power to buy and sell foreign bills of exchange, it becomes clear that it will contribute, aside from its mere function of note issue, to create a mass of readily convertible commercial paper which will make the money-market in America no longer the reflection of the whims and follies of speculators on the stock exchange, but the index of the demand for capital by sober and constructive commercial interests.

The fear which has been expressed in some quarters that a central banking institution would be under the control of "Wall Street" is likely to turn ultimately, when the plan is carefully examined, into the conviction that it will be the most effective curb on Wall Street. Among the restraints which are imposed upon control of the new institution by any small group of men or special interests are the following:

1. *Form of organization.*—The method in which the Reserve Association is to be organized comes as near to representative democracy as could well be attained in a banking mechanism. The capital of $300,000,000 is to be made up by the national banks, under conditions which make it probable that few or none will fail to participate. Each national bank, however small, is authorized to subscribe for the capital of the Reserve Association to the amount of twenty per cent. of its stock. Each subscribing bank becomes a member of a local association and has a share in its government. The local associations are grouped into fifteen districts and the district board is in turn chosen largely by the participating banks. The board of directors of each division is required to add to its banking members by the election of additional directors equal to one-third the number of local associations in the district. These additional directors are not to be bankers, but are to be chosen from the industrial, commercial, agricultural and other interests of the district. To form the central board of directors of the Reserve Association, fifteen directors are to be first chosen—one by the board of directors of each branch. In order to introduce a still further element of democracy, twelve directors are to be chosen by voting representatives of the banks in each of the fifteen branches. These members of the board, with the representatives of the government, are to elect twelve additional members, who shall in their turn be chosen from the industrial, commercial, agricultural and other interests of the country and who shall not be bankers.

2. *Participation by the Government.*—In order that everything done by the association may be done in the light of day, the board of directors is to contain three representatives of the Government as *ex officio* members—the Secretary of the Treasury, the Secretary of Commerce and Labor and the Comptroller of the Currency. They are not only to be members of the board of directors, but the Comptroller of the Currency is to be also a member *ex officio* of the ex-

ecutive committee of nine. Thus no important loans, no changes in the rate of discount, or any measure of general policy, can be carried out without the knowledge of the responsible officers of the Federal Government.

The principal officers of the Reserve Association itself,—the governor and two deputy governors,—are to be selected by the President of the United States from a list submitted by the board of directors, and the governor is subject to removal by the President for cause. These provisions stop half-way between the direct appointment of the executive officers by the Government, which prevails in most of the countries of continental Europe, and absolute freedom in the choice of officers by the bank itself, which is the present policy in this country. It might be an improvement over the proposal of Senator Aldrich if the initiative in selecting these officers were left to the directors of the bank, with only the veto power vested in the President of the United States. Under such an arrangement, it is hardly conceivable that conflict would arise. The directors, even if they had the wish, would not dare send to the President the name of a banker whose name was tainted with speculative ventures or who did not command the unquestioning confidence of the most conservative elements of the community.

One of the provisions for excluding politics from influence in the management is that no member of any national or State legislative body shall be a director of the Reserve Association, nor of any of its branches, nor of any local association. In this respect the project follows the law of 1897 in France, which first prohibited a member of the Chambers from serving as governor of the Bank of France and which compelled the resignation of M. Magnin and the substitution of M. Pallain, the present governor.

3. *Character of business permitted to the bank.*—The functions of the Reserve Association, as defined in the Aldrich project, as already pointed out, are restricted to commercial banking. It may rediscount notes and bills of exchange arising out of commercial transactions; it may purchase short-term acceptances and may deal in foreign bills of exchange. The direct functions of the bank are restricted to aiding in the production and exchange of goods. They will react only indirectly, through the greater stability and security of financial conditions, upon the investment of capital in fixed forms and upon the market for securities.

Thus, there is no essential benefit to be obtained from controlling the loan funds of the association. Their use is restricted by the plan to the actual producing interests of the country, which are turning raw material into finished goods and throwing them on the market in exchange for short-term commercial paper. Under the project as it stands, the central institution is not authorized to engage in underwritings or the offer of loans, even those of the Government, nor to lend on stocks and bonds; so that the motive which influenced the control of the resources of the big insurance companies,—that they might be employed in absorbing new securities and in lending on them for speculative purposes,—would be wholly lacking.

4. *Limitation of the dividend paid.*—The new project provides that the dividend to stockholders shall be four per cent. and shall in no case exceed five per cent. After their dividend has reached five per cent., any further excess of profits is to be divided—one-half to the surplus of the Reserve Association and one-half to the Government. When the surplus has reached twenty per cent. all excess earnings go into the public Treasury.

In providing that the functions of the central banking mechanism shall concern only commercial transactions, and that these functions shall be exercised through an organization the control of which reaches back to the small banks of the country, the plan of Senator Aldrich extends the principle of democracy from political affairs to our financial system. It becomes no longer, as under existing law, a democracy which is scattered, unorganized and helpless. It is a democracy which comes into its own, through the representative system, by which the influence of the humblest in the financial world reaches up, through this power of representation, to the seats of the kings of finance. Through this organized democracy of finance and through the substitution of commercial banking for speculative banking, the tendency of such a system must inevitably be to limit the power of "Wall Street" and the great financial interests to their legitimate field. In the field of commercial banking the new plan proposes to substitute the system of ordered self-government, as it exists in the American political world, for the appearance, at recurring intervals, of the financial Cæsar or Napoleon, who comes forth in great emergencies as the savior of financial society.

Charles A. Conant.